EconomicUpdate NATIONAL
Federal Reserve Bank of Dallas

# Getting Back on Track

**June 23, 2011**

The first quarter of 2011 could be characterized as a recovery ready to gain steam but held back by temporary factors. These include high oil prices, supply-chain disruptions and extreme weather. Economic data for the second quarter have been unambiguously soft, indicating that the first-quarter weakness carried over into the second. Constraints on growth will likely ease in the upcoming months, giving rise to a stronger recovery in the second half of the year.

### Headwinds Likely to Fade

Nonfarm private payrolls increased by only 83,000 jobs in May. This was down from the 206,000 average pace of jobs growth in the first four months of the year, erasing hopes that the labor market would brush off higher gasoline prices. The slower pace of job creation was not confined to goods-producing industries, as one would have expected if disruptions related to the Japanese earthquake and tsunami were the only factor (*Chart 1*). Surveys of manufacturing activity also have shown weakening, extending into early June.

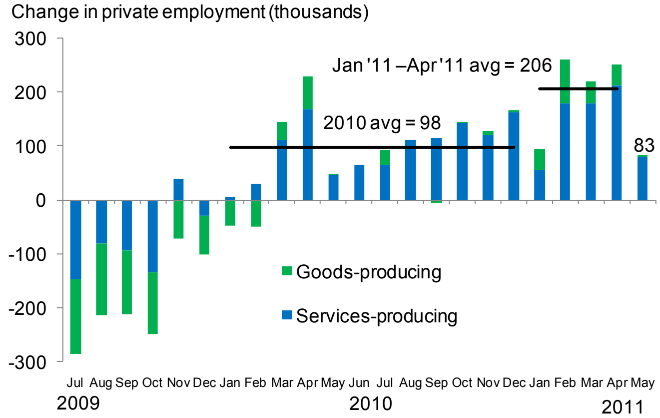
The constraints that held back growth in the first half of the year should soon fade. Oil prices have fallen back from their April peak, lowering business costs and freeing up consumer purchasing power. Auto production in U.S. plants is expected to return to normal levels by the fall of 2011, as tsunami-related supply-chain disruptions dissipate. Using financial indicators that have a good track record predicting real gross domestic product (GDP) growth three quarters out (the S&P 500 stock price index, junk-bond spread, the probability of recession based on the 10-year–1-year yield curve and oil price increases adjusted for domestic demand), real GDP is expected to grow at an average annualized rate of between 3.0 and 4.0 percent in the third and fourth quarters of 2011—enough to put significant downward pressure on the unemployment rate.

### Recent Growth Pattern a Correction of Past Excesses

The labor market has essentially been treading water since last June, with the unemployment rate having declined by less than half a percentage point, from 9.5 to 9.1 percent. This poor performance reflects modest, 2.5 percent annualized real GDP growth over the past three quarters. Growth contributions from final private domestic demand, government purchases and inventory investment have all been unusually small compared with recent past expansions (*Chart 2*). Only net-exports' growth contribution has surprised on the up side.

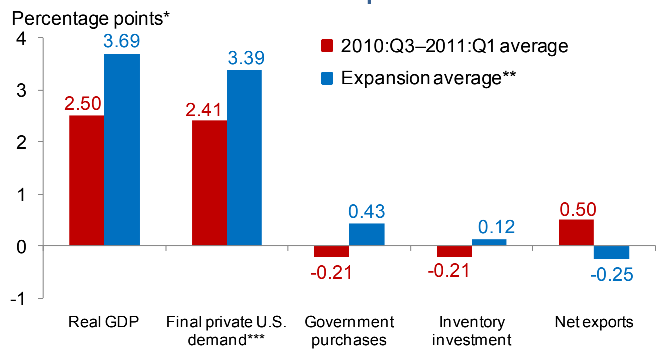
To a considerable extent, the recent growth pattern is a reaction to and correction of the excesses of the past. Strikingly, while gross domestic product was never appreciably above potential during the expansion that led up to the 2008–09 recession, domestic demand was, and by a wide margin (*Chart 3*). As a nation, we were consuming far beyond our means: Real gross domestic purchases as a percent of potential GDP

**Chart 1**
**Private Employment Decelerated in May**



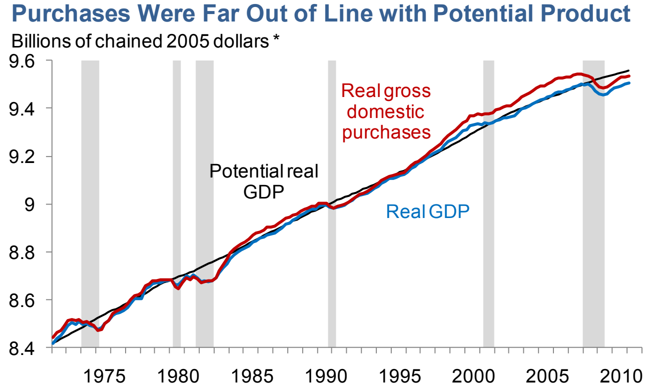

SOURCE: Bureau of Labor Statistics.

**Chart 2**
**Real GDP Growth Remains Subpar**




*Annualized contribution to real GDP growth.
**1983-2008, excluding recessions and the following four quarters of recovery.
***Personal consumption expenditures and fixed investment.
SOURCE: Bureau of Labor Statistics.

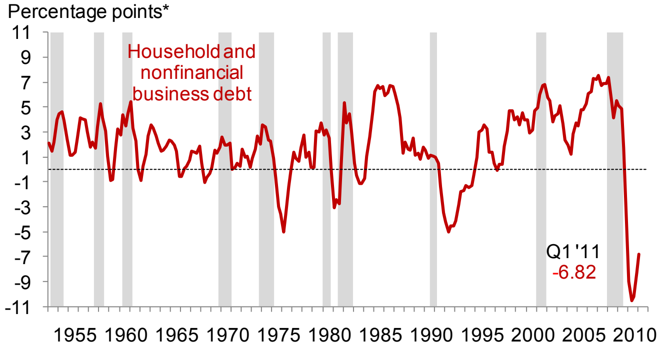
**Chart 3**
**Purchases Were Far Out of Line with Potential Product**




*Logarithmic scale; seasonally adjusted, annualized rate.
NOTE: Shaded areas represent recessions.
SOURCES: Bureau of Economic Analysis; Congressional Budget Office.

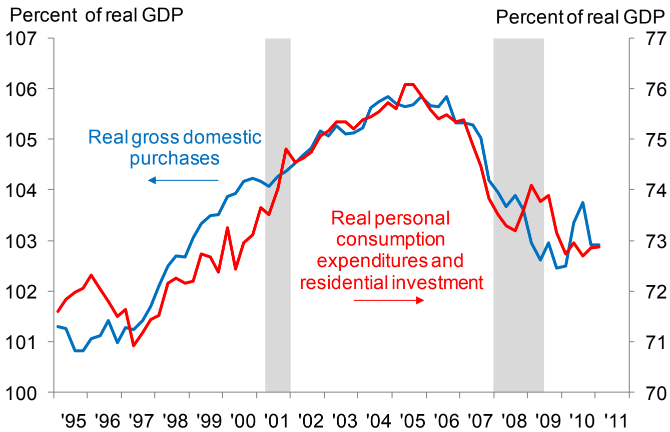
reached 107.0 percent in first quarter 2006—a percentage surpassed only in the late stages of the high-tech boom and, before that, matched only at the peak of the Vietnam War.

### Chart 4
### Debt Accumulated Rapidly During the Period of Excess Domestic Demand



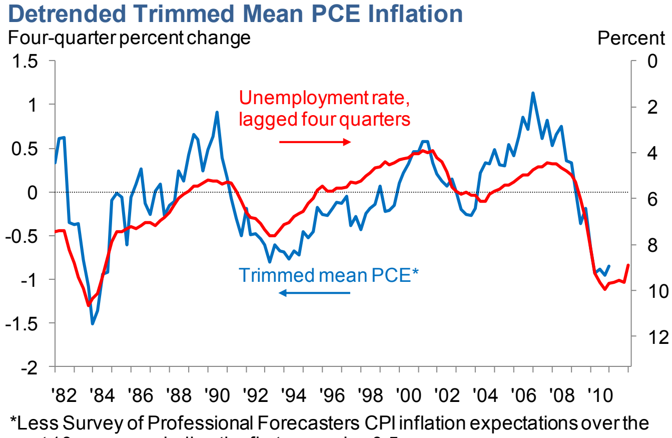

*Four-quarter change in debt as a percent of GDP.
NOTE: Shaded areas represent recessions.
SOURCES: Federal Reserve Board of Governors, Bureau of Economic Analysis.

### Chart 5
### Consumption and Housing Pushed Purchases Above Production




NOTE: Shaded areas represent recessions.
SOURCE: Burea of Economic Analysis.

### Chart 6
### Unemployment Rate Is Negatively Correlated with Detrended Trimmed Mean PCE Inflation




*Less Survey of Professional Forecasters CPI inflation expectations over the next 10 years, excluding the first year, plus 0.5.
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas; Federal Reserve Bank of Philadelphia; authors' calculations.

Real exchange rates are supposed to adjust to prevent large, persistent imbalances between domestic demand and potential output by raising the prices of foreign-produced goods and traded services relative to those of domestically produced goods and traded services. If nominal exchange rates don't do the job, the required adjustments to the real exchange rate are eventually accomplished via movements in domestic and foreign product-price inflation rates. But this process is slow and uncertain, and from 1997 through 2005, the goods and services we purchased were consistently cheap relative to the goods and services we produced. Meanwhile, foreign purchases of dollar-denominated securities kept U.S. real interest rates low, facilitating rapid growth in private-sector indebtedness (*Chart 4*).

The increased borrowing was decidedly not used to finance an expansion of the U.S. economy's future production capacity: The post-1996 surge in gross domestic purchases relative to gross domestic product is almost entirely accounted for by increases in consumption and residential investment relative to GDP (*Chart 5*).

That which cannot continue won't, and we are now seeing relatively sluggish growth in consumer demand as households—realizing that they have overextended themselves—seek to trim debt. We are also seeing foreign product-price inflation rise relative to domestic product-price inflation, which is stimulating net exports. So, the imbalances of the past are slowly being corrected.

**Inflation Outlook**

Inflation has three components: (1) a long-run trend that is primarily determined by expected future monetary policy, (2) medium-term deviations from the long-run trend due to resource slack and changes in slack and (3) short-term movements due to transitory influences from a variety of sources. This last component is just "noise" that disguises where inflation is heading. To eliminate as much of this noise as possible, economists at the Dallas Fed look at "trimmed mean" inflation measures. These ignore the largest upward and downward price movements, regardless of their source: Unlike conventional "core" inflation, trimmed mean inflation doesn't arbitrarily exclude food and energy prices.

What of the other two components of inflation? Judging by surveys of long-run inflation expectations or a comparison of yields on regular and inflation-protected Treasury securities, the long-run trend in inflation drifted irregularly downward during the 1980s and most of the 1990s, but has held steady (at about 2 percent for the personal consumption expenditure price index) from 1998 onward. Deviations in inflation from this trend are affected by resource slack, as demonstrated in Chart 6. With unemployment high and likely to remain so for some time, inflation won't be a problem over the next several years, provided nothing happens to shake the public's confidence in the Federal Reserve's commitment to long-term price stability.

—Evan F. Koenig and Tyler Atkinson

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**About the Authors**

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